DOW THEORY LETTERS INC.

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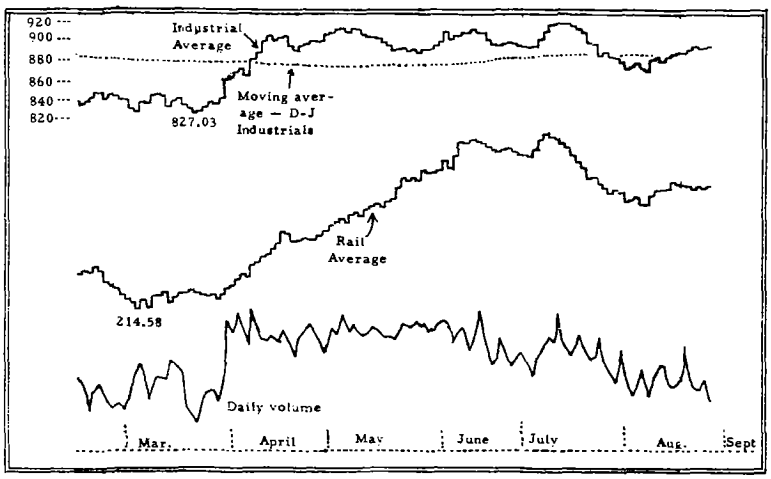
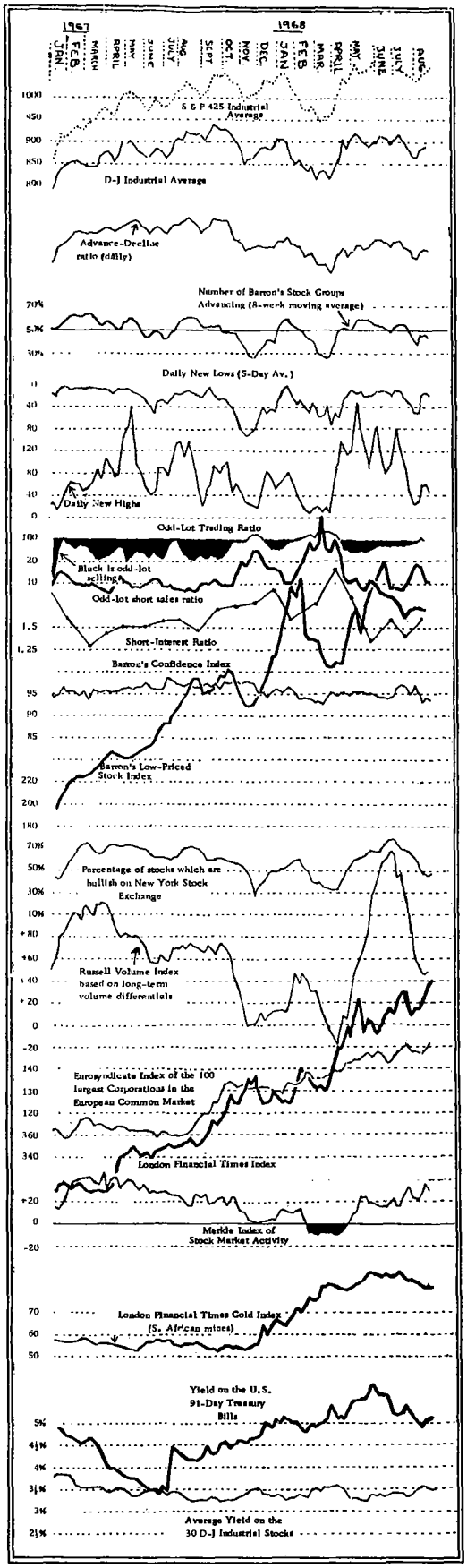
THE MARKET: Despite the excitement of the shocking and messy Democratic campaign in Chicago, despite the tension of developments in Czechoslovakia, the market has been putting on a listless performance.

The Industrial Average poked its head temporarily above the 895 level (896.13 on August 26) while the Rails diverged in direction, Volume on the rally dropped consistently below the 10 million share market, a "low level" when compared to the action of the past six months.

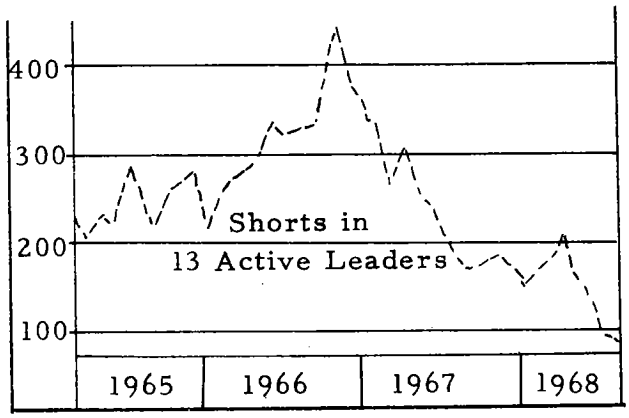
The single interesting action occurring in the market took place on August 27 when the Utility Average broke below its early August bottom of 130.78 to sink to its lowest level since early June. This poor performance by Utilities is striking for two reasons: (1) the Utility Average often leads the rest of the market, and this high-grade Average has now formed a long, dragged-out "head-and-shoulder" top, (2) the desultory performance in Utilities (which are often classified as defensive, money-rate issues) has occurred in the face of a fractional drop in the discount rate and the general opinion that interest rates are headed down.

Aside from the downtrend in Utilities, this market is providing few hints as to the next broad trend of stock. Odd-lotters are again on the selling side of the market, and at face value this must be considered a plus. The short interest is as much a mystery as ever, for the N.Y.S.E. shows a jump in total shorts to 21.5 million shorts, an increase in the short interest of 1.4 million for the month. Yet Garfield Drew's compilation of the short interest in 13 active stocks (which he has been running for years) shows a new low (see chart on page 2) below 100,000. Thus Drew's adjusted figures show a drop from the above 400,000 shorts at the 1966 high to the below 100,000 figure of August, 1968. The latest figure on Drew's studies is the lowest in years and can hardly be considered bullish.



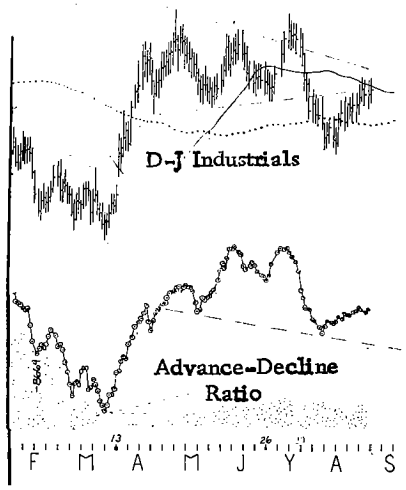

1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's Stock Groups Advancing (8-week moving average)
Daily New Lows (5-Day Av.)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurosyndicate Index of the 100 largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Financial Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

The N.Y.S.E. short interest ratio during August rose to 1.63 from 1.41 the previous month. I have not yet received the short interest ratio figure for the 30 Dow stocks, and this more significant (in my opinion) figure will be published when I receive it from my friends at Indicator Digest (see Letter 401).



One further technical comment at this time. I include on this page a chart (courtesy of Quote Digest) of the daily action in the Dow Industrials and the comprehensive advance-decline ratio on the N.Y.S.E. While the Dow pattern appears rather nebulous, I feel that the pattern in the advance-decline ratio is potentially bearish. Note the descending bottom in the ratio since March, 1968, plus the rather weak rally of recent weeks. It all adds up to a picture of distribution with a definite head-and-shoulders effect in the advance-decline ratio.

In my opinion, a decline in the ratio below the dashed, downsloping "neckline" on the chart would suggest a further broad and severe descent for the mass of issues on the senior Exchange. The picture of the advance-decline ratio, as seen on this chart, is weaker than that of the Dow. A completion of the symmetry seen in this pattern would indicate the possibility of weakness arriving during September and October.



PERSPECTIVE: In his studies of bull and bear market history, the great Dow Theorist Robert Rhea concluded that bear markets tend to last one-third to one-half as long as the bull market which precedes them. During the 1930's (when Rhea made this statement) no one found this observation particularly difficult to accept. After all, most of the bull markets of which there were any record were not particularly long, and the idea of a bear market lasting one-third to one-half as long as the preceding bull market was not a particularly shocking or threatening idea.

Looking back we note the bull market of 1921-29, a giant eight year bull market. The subsequent bear market of 1929-32 was indeed a long bear market, but the bear market did end in July, 1932 at 41 on the Dow. By 1937 the Dow had better than quadrupled. What was shocking during the 1929-32 period was not its duration so much as the severity. By July, 1932, the Dow Industrials had lost 89 percent of its September, 1929 value. This was the severest collapse in bear market annals, it was a disaster by any reckoning. Furthermore, the 89% decline in the Dow predicted more than a decade of sub-normal or depressed business conditions. Things got better during 1936 and 1937, but business conditions did not get "boomy" again until World War II in the early 1940's.

One thing which has bothered me is the length of the 1949-1966 bull market. That bull market by any reckoning was the longest bull market in history, lasting 17 years. Suppose we applied Rhea's simple and innocent "rule" of bear markets, that bear markets tend to last one-third to one-half as long as their preceding bull market. This would mean that following 1966 we could expect a bear market of approximately five to eight years. Such a thing did not (and still does not) seem possible. Yet, in thinking about it I can now see how a five-year bear market could easily occur.

The bull market, measured by the Dow Industrials, topped out in February, 1966 at 995.15. Two-and-one-half years have now elapsed, and the Dow has yet to surpass its 1966 high. Even more fantastic, the majority of investors are still arguing as to whether we are in a major bull or bear market. From the optimist's standpoint, it can be said that no great collapse has yet occurred, and although many individual stocks are now well

off their highs, others have pushed to new record highs. The argument about "a market of stocks" can still be applied, and if an investor were out of the Dow stocks and in the right glamour or growth issues, he might not even now know we are in a bear market. And if you are not aware you are in a bear market, can you be in one?

From the bear side it can be pointed out that never since the bull market started in 1949, has the Dow failed to push to a new high within a period of two-and-one-half years. True, no collapse has yet taken place, but neither has the Dow bettered its 1966 peak. Something new and different has occurred on Wall Street, and, say the bears, the something which is new is that the market is caught in the grip of a particularly treacherous and deceptive bear market.

Personally, I subscribe to the bear view. I believe that we have been witnessing a fabulous, extended "fooler" so far, and that all that can be said is that the Dow is establishing a series of annual descending tops. The odds are that as long as the series of lower tops holds intact, sooner or later the Dow is going to mount an attack on the lows. The bear market bottom was recorded in October, 1966 at 744.32. All history indicates that if the market cannot go one way, it is ultimately going to go the other way. Therefore, I believe that the longer the elapsed time without a new high in the Dow, the better the odds that we are going to witness a new low (below 744.32).

If we are indeed in a primary bear market, then we must concede that two-and-one-half years have already elapsed. Ironically, the public during this period has been extremely bullish, much more bullish than they were during most of the 1949-1966 period when a primary bull market was on. But when we think about it, this is as it should be. We know that the public does tend to be on the wrong side of the major trend, and I believe that the public has been on the wrong side of the trend since 1966.

I would guess that with the public still bullish two-and-one-half years after the Dow top, and with the Dow now only 100 points below its bull market peak, the "pleasantest" part of this bear market is now behind us. I would guess that this bear market could last a total of around five years, and if so I feel that the really rough period is ahead.

Just as the years 1949, 1950, 1951 did not attract the public into the market, and just as those first three years of the bull market did not "seem" like real bull years, so the years 1966, 1967 and 1968 have not frightened the public, and those years have not felt like real bear years.

But I warn readers that primary trends do finally express themselves. And usually the longer they go without a true expression, the more violent the action when the primary trend finally emerges for all to see. My conclusion, therefore, is that we will probably face some discouraging downside action during the next couple of years, action which will leave no doubt in anyone's mind as to whether this is a primary bear market or not. Time will tell.

NEW ECONOMICS: After years of tampering and manipulating, there is little doubt that the famous "New Economics" is now on trial. The New Economics is basically a distortion of a few of Lord Keynes' basic theses. Keynes believed that the nation should resort to deficit spending during times of economic contraction in order to pump up the economy. Then, during periods of economic expansion Keynes believed that the nation should run cash surpluses to hold back the forces of inflation.

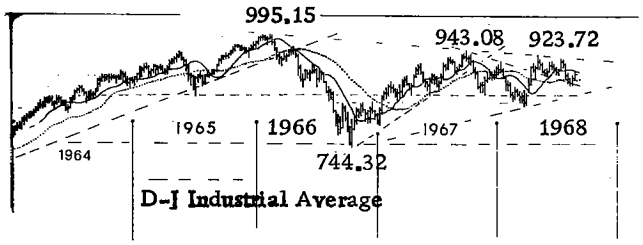
The New Economics, which is politically oriented, holds that the economy should vary from good to boomy at all times, subject to the "fine tuning" of the various monetary authorities. During the period of New Economics influence, the nation has kept the unemployment rate (politically a huge plus) at very low figures. But the cost has been severe. The U.S. has lost the majority of its gold, it has run mountainous deficits, and it has had to resort to fiat (no-gold backed) paper money and practically valueless coinage.

As a result the dollar has come under periodic attack since 1960, each attack being more severe than the last. On top of this, interest rates have had to be held at historically high levels, and since 1966 at record levels. In the face of continuous huge expansion in the money supply, prices have run rampant, and inflation has become a way of life for all Americans.

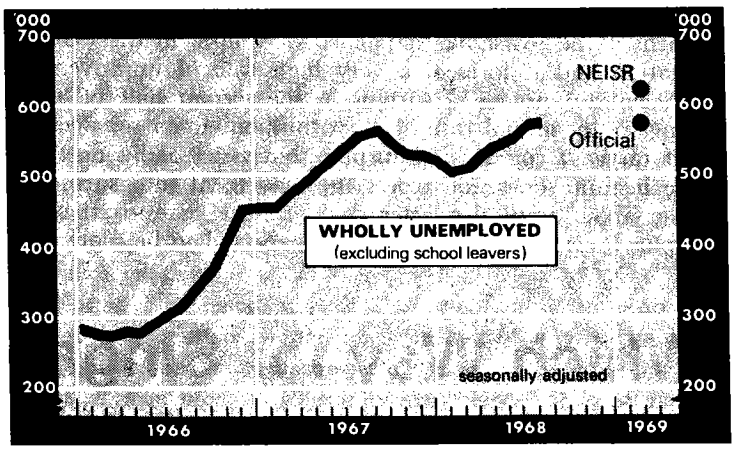
The two current gods of the New Economics are Walter Heller and John Galbraith. As noted by George Lindsay in his last week's report, both of these men are now sounding warnings about what is going on. Galbraith sees stock speculation as the potential bogeyman, and he notes in a recent issue of Playboy Magazine that if there is ever another economic breakdown in this country, it will stem from Wall Street. This is a normal reaction from the author of "The Great Crash," a scholarly history of 1929 and its aftermath.

On the other hand, Heller in Harper's Magazine worries that economists have not been able to bring about full employment while at the same time keeping prices stable. Thus they must run the potential risk of inflation or recession, neither one a too palatable choice (although the New Economics would always rather follow the politically acceptable course which is inflation).

In the current issue of Barron's (August 26) Max Shaprio compares today's speculation in high-multiple growth stocks with the tulip mania in Holland during the 17th Century. His comparisons are both studious and ominous. There is little doubt but that Shapiro sees an unpleasant aftermath from the current practice of buying a stock at a high price on the theory that you can sell it to another speculator at a still higher price.



To get back to the current Wall Street situation, while the "cats-and-dogs" and glamour shares have been bouncing up towards the blue sky, the giant investment grade stocks making up the Dow Industrial Average have been doing otherwise. In fact, since the 1966 bull market top only four of the thirty Dow stocks have managed to post record highs. As seen on this little weekly chart (courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas), the Dow Average has been establishing a series of ominous descending tops during 1966 (995.15), 1967 (943.08) and 1968 (923.72). Thus my conclusion is that informed investors have been distributing the "back-bone of America" stocks while speculators have been rushing into fancy price-multiples and science-wonder issues.

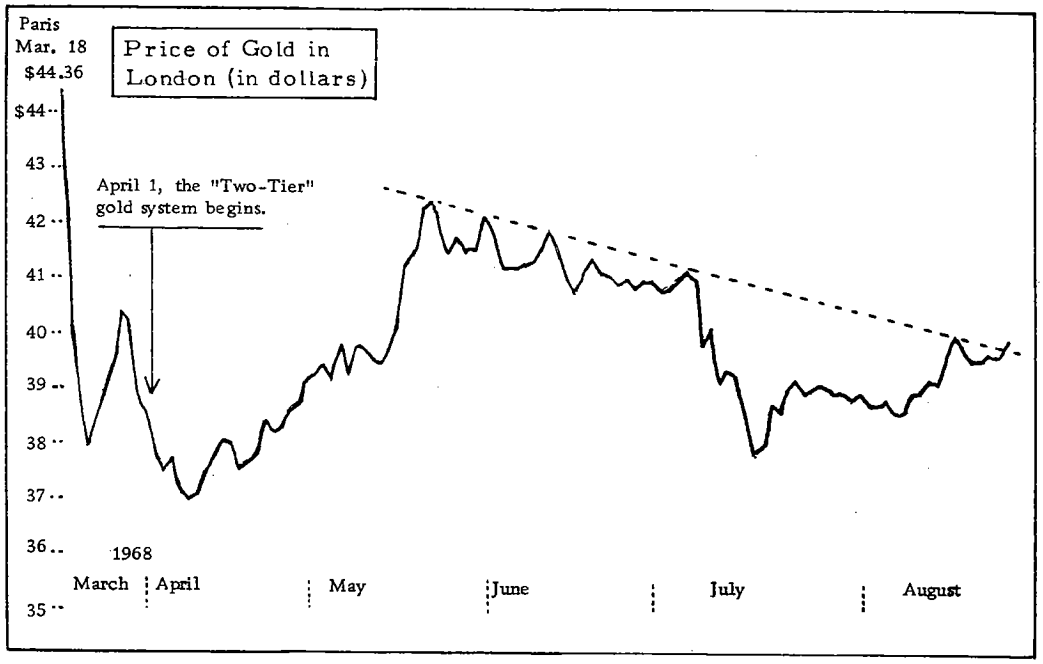


I have been warning about this primary bear market ever since the February, 1966 peak in the Dow. No one knows how the bear market will develop or what will set off the ultimate collapse. But I would guess that the cave-in, when it comes, will be set off by an international monetary crisis and gathering clouds of depression in Europe. I include this little chart from the August 24 issue of the London Economist, a chart which shows steadily mounting unemployment in Britain. The unemployment has come despite last November's pound devaluation and despite a series of desperate British deficits with accompanying spiralling inflation. Britain's National Institute suggests that by the end of 1969, unemployment in England could rise to 750,000, a figure which will appear frightening if it materializes.

France, too, is facing rising unemployment and economic troubles. France is losing $50 to $60 million in foreign exchange weekly, and francs are now being peddled at 10% to 15% discount abroad. Shares in foreign companies are bringing premiums of around 15% on the Franch Bourse, and it seems entirely possible that a French devaluation of up to 25% could materialize in the face of the current outpouring of foreign exchange.

In Britain the present harsh regulations require that 25% of the proceeds from the sale of foreign securities must be paid to the Government. Despite this, foreign equities are bringing premiums of up to 50% on the British exchange. This rush to get out of pounds, of course, means that the pound in terms of many foreign stocks is worth only $1.60 rather than the official rate of $2.40. Last week the British stock market average, propelled by fears of inflation and the possibility of another pound devaluation, pushed through the 500 level as investors rushed to swap currency for equities.

What happens next? The picture is hardly a happy one. First one currency, then another, succumbs to weakness. When one currency is bolstered via international loans or some other manipulation, another currency slides. It has become a game of monetary Russian roulette, and before very long the pistol hammer is going to fall on a loaded chamber. The smash could occur in the pound, the franc or even the dollar. Neither I nor anyone else can predict from what quarter the explosion is coming, but I would bet that it <u>is</u> coming and <u>soon.</u> When that happens, there promises to be a monetary upheaval of major proportions, together with panic on the stock exchanges of the world. This is what I expect sometime during late 1968 or perhaps during 1969. It's a once-in-a-generation phenomenon, and the only protection against it for the investor is liquidity and a hedge in gold shares. And liquidity (out of stocks, real estate, commodities, etc.) and a position in gold shares is exactly what I have been recommending.



<u>GOLD:</u> In the August 29 Wall Street Journal there appeared a little article entitled, "South Africa's Gold Stock Fell Last Week Due to Sales." This is particularly interesting, because in the face of these sales the price of gold on the London market continues to edge up from its July low (see chart).

In fact, note on the chart that on the August 29 closing price of $39.85, the dollar price of gold has reversed a long declining trend which began at last May's semi-panic highs. I would guess that the price of gold, despite continuing S. African sales, is now beginning an uptrend with the next significant point being the July high of $40.15.

Meanwhile, the world grows uneasy at the U.S. insistence upon a downgrading of gold as a monetary metal. And why shouldn't the world fret? Europe now owns over $21 billion of gold in its Central Banks against the $10 million owned by the U.S. A week ago this article appeared in the <u>New York Times,</u> and it is, of course, a warning by the Swiss that any attempt by the U.S. to embargo gold would be greeted by a European gold bloc, a bloc which would refuse to accept paper dollars in trade. In other words, Europeans are saying that they have, in fact, a claim on America's remaining gold, and if the monetary axe falls they reserve the right to get that gold. They are further saying that they will not deal in a currency which cannot be exchanged for gold.

Swiss Warns U.S. On a Gold Freeze

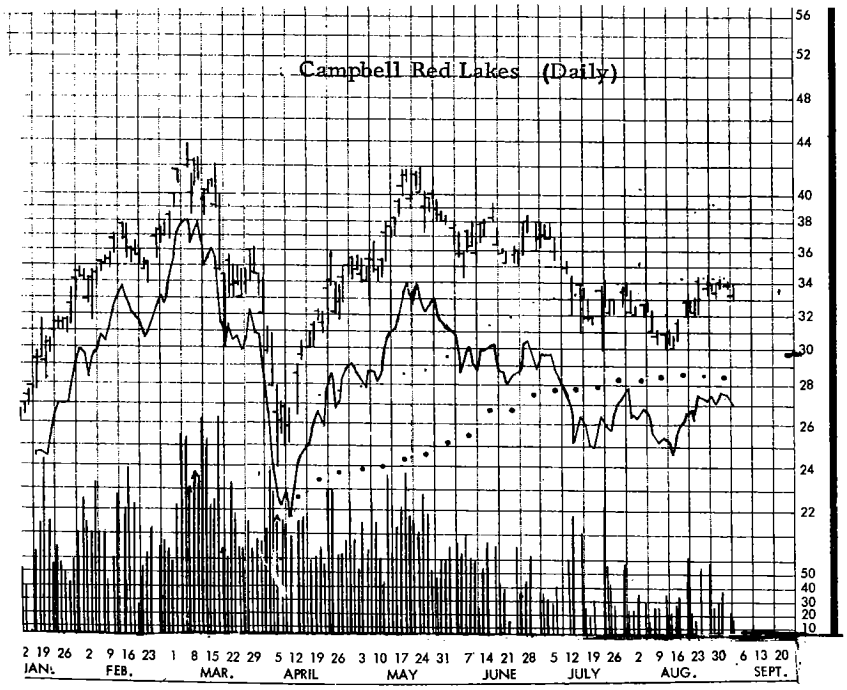
ZURICH, Switzerland, Aug. 16 (Reuters) — A leading Swiss banker warned today that certain European countries could set up their own gold bloc if the United States tried to create a dollar standard, by putting an embargo on its remaining gold reserves.

In an interview with the authoritative Neue Zuercher Zeitung, Dr. Franz Aschinger, economic adviser to the Swiss Bank Corporation, said such a split in Western monetary solidarity would have serious trade and financial consequences.

Dr. Aschinger, a supporter of a higher official gold price, said that, if gold were demonetized by the Americans, a dollar standard would emerge, which would make other countries more dependent than before on

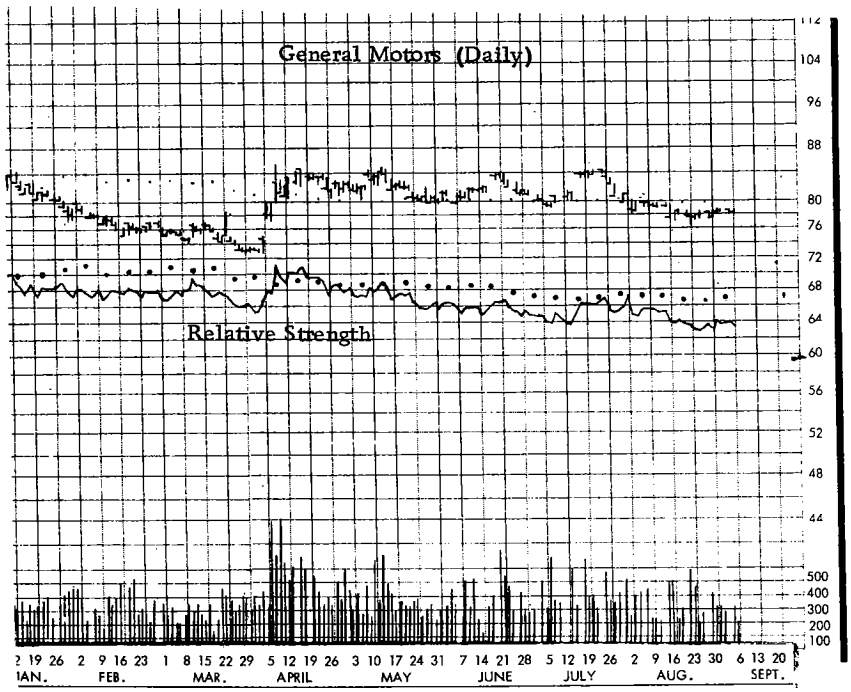
DOW THEORY MARKET LABORATORY PAGE

A number of interesting factors are occurring in this market, all of them suggesting that the recent rally is about to run out of steam. First, as mentioned on page 1, the Utility Average has broken to its lowest level since early June. Second, the bellwether 91-day Treasury bills (see page 1 composite chart), having dropped temporarily into the 4.9% yield range, are now pushed up to where they yield 5.17%. The lower Utility Average and the higher bill rates indicate monetary tightening— perhaps monetary trouble.



Next we have the potential reversal formation in many of the gold shares. I include a daily chart of Campbell Red Lake for purposes of illustration. Here we see the newly-formed head-and-shoulders bottom. A rise into the 35 area would mean that CRK had broken out on the upside, and this could coincide with the reversal in the gold price chart.

Finally, the pattern of the great bellwether issue, General Motors, is again worth examining. Here we see GM breaking below its 79-80 low range of April-July, and sinking back to the lowest level since early-April. At the same time, GM's relative strength line has declined to its lowest level of the year. This gradual fading of strength in America's greatest manufacturing company does not bode well for the market. As a rule, a top and subsequent weakness in GM indicated forthcoming weakness for the market as a whole.



Charts courtesy of Traders Research, 101 Cherry, Alton, Ill. 62002.